

Mistra Indigo

WHITE 1
PAPER
2012 | 10 | 24

U.S. STATUS ON CLIMATE CHANGE MITIGATION

By Dallas Burtraw and Matt Woerman



This report is also published as
Mistra Indigo Policy Paper nr. 1

The Mistra Indigo program is aimed at developing tools and instruments that in an internationally coordinated, cost-effective way can support climate efforts “bottom up”, i.e. independent of international frameworks.

Mistra Indigo is financed by the Swedish Foundation for Strategic Environmental Research (Mistra).



ABSTRACT

In 2009, President Obama pledged that, by 2020, the United States would achieve reductions in greenhouse gas emissions of 17 percent from 2005 levels. With the failure of Congress to adopt comprehensive climate legislation in 2010, the feasibility of the pledge was put in doubt. However, we find that the United States is near to reaching this goal; currently the country is on course to achieve reductions of 16.3 percent from 2005 levels in 2020. Three factors contribute to this outcome: greenhouse gas regulations under the Clean Air Act, secular trends including changes in relative fuel prices and energy efficiency, and subnational efforts. Perhaps even more surprising, domestic emissions are probably less than would have occurred if the Waxman – Markey cap-and-trade proposal had become law in 2010. However, at this point the United States is expected to fail to meet its financing commitments under the Copenhagen Accord for 2020.

ABOUT THE AUTHORS



Dallas Burtraw from Resources for the Future is one of the foremost experts in the US on environmental regulation in the electricity sector. For two decades, he has worked on creating a more efficient and politically rational method for controlling air pollution.

In the Mistra Indigo program Burtraw is deeply involved in several of the research areas, and his insight into the political process in the US has proven very beneficial to the program.

Dallas Burtraw
Resources for the Future
e-mail: burtraw@rff.org
phone: +1-202-328-5087



Matt Woerman is a Research Associate at Resources for the Future in Washington, DC. His research interests include policies and regulations affecting the electricity sector.

Matt Woerman
Resources for the Future
e-mail: woerman@rff.org
phone: +1-202-328-5110

CONTENTS

U.S. Status on Climate Change Mitigation	3
Introduction	3
Greenhouse Gas Regulation under the Clean Air Act	4
<i>Mobile Sources</i>	5
<i>Permitting for Stationary Sources</i>	5
<i>Performance Standards for Stationary Sources</i>	5
Secular Trends in Natural Gas Supply and Energy Efficiency	6
Subnational Policy	7
Adding Up the Pieces: Projected U.S. Emissions in 2020	7
Emissions May Be Lower Than under Cap and Trade	8
<i>Domestic Offsets</i>	11
<i>Fuel Economy Standards</i>	11
<i>Banking Sensitivities</i>	11
Conclusion	12
Footnotes	14
References	14

U.S. STATUS ON CLIMATE CHANGE MITIGATION

By *Dallas Burtraw and Matt Woerman*

INTRODUCTION

At the international climate meetings in Copenhagen in December 2009, President Obama pledged that, by 2020, the United States would achieve reductions in greenhouse gas (GHG) emissions of 17 percent from 2005 levels.¹ Most observers have anticipated that, with the failure of the United States to adopt comprehensive climate policy through legislation in the 111th Congress (2009-2010), the pledge would not be met. This paper presents a forecast for U.S. emissions in 2020. Substantial uncertainty remains because important regulations are still pending. Nonetheless, our central estimate indicates that the United States is near to reaching this goal;

currently the country is on course to achieve reductions of 16.3 percent from 2005 levels in 2020.

Three factors contribute to this emissions projection. First is regulation under the Clean Air Act. The U.S. Environmental Protection Agency (EPA) has already finalized fuel efficiency standards for mobile sources and rules for preconstruction permitting under the Act. The most important regulation from EPA will be the expected operating performance standards for new and existing stationary sources, and the design and stringency of these standards is the most important source of uncertainty in our estimate. A second factor is the secular trends in fuel prices and energy efficiency.

THIS PAPER TARGETS

- » International climate negotiators.
- » U.S. policy makers, regulators and NGOs.

KEY MESSAGE

» The authors find the U.S. is on target to achieve GHG reductions, in the year 2020, of 16.3 percent from 2005. This reduction is near the 17 percent pledge by President Obama at the international climate meetings in Copenhagen in December 2009.

» Despite the lack of federal climate legislation, current

subnational policies and changing trends in the electricity sector have led to important reductions in GHG emissions. Most importantly, regulations under the Clean Air Act are poised to further reduce GHG emissions over the next decade.

» Domestic emissions are probably less than would have occurred if

the cap-and-trade proposal had become law in 2010, because that program would have provided for substantial international offsets.

» However, at this point there is no plan in place that would enable the United States to meet its financing commitments under the Copenhagen Accord for 2020.

The advantageous change in relative fuel prices has led to a substantial shift toward the use of natural gas and away from coal for electricity generation. Meanwhile, a discernible reduction in the energy intensity of economic activity is stemming from the expanded role of energy efficiency. The economic recession has also had an overall influence on reducing current emissions, but this will have less of an influence by 2020. The third factor is the effect of subnational efforts to reduce emissions, including cap and trade in California and 9 northeastern states, renewable portfolio standards for electricity generation in 29 states, and energy efficiency resource standards in 24 states.

The United States is about on track to achieve President Obama’s Copenhagen pledge with respect to mitigation goals. Perhaps even more surprisingly, emissions in the domestic U.S. economy under the current status quo, which we label the Clean Air Act regime, will probably be less in 2020 than would have occurred if the Waxman – Markey cap-and-trade proposal (H.R. 2454) had become law in 2010. That legislation would have achieved a roughly 30 percent reduction in emissions by 2020, but two-thirds of those reductions would have come from international and domestic offsets and many of those emissions reductions would have contributed to a bank of emissions allowances that would have reappeared as emissions in later years. The legislation also would have preempted many of the activities that are responsible for emissions reductions under the Clean Air Act regime. On the other hand, the legislation also would have offered a greater element of certainty with respect to the U.S. emissions profile and presumably a lower cost, even if the expected level of emissions reductions would have been less.

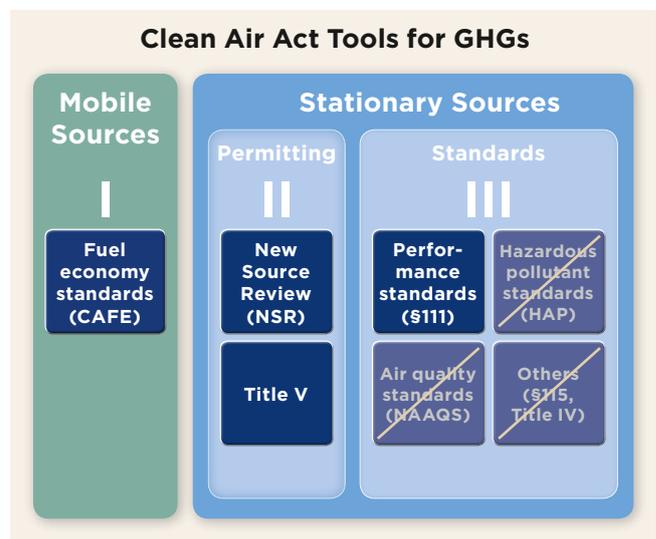
Although the United States is close to meeting its pledge regarding domestic emissions, one must be less optimistic about the ability of the country to fulfill its pledge for international financing. The United States joined other developed countries in committing to support emissions mitigation and adaptation in developing countries through financing that would grow to \$100 billion per year from public and private sources by 2020. However, the United States has not put a plan in place to achieve its share of this commitment (Purvis 2012). The public contribution to the financing goals in future years appears to be insufficient. The contribution of private capital, including payments for international offsets, was expected to fulfill the lion’s share of the U.S. financing commitment but international offsets play

no role in meeting regulations under the Clean Air Act (Richardson 2012). Private investment capital in energy resource development already substantially exceeds the \$100 billion target, but this cannot be seen as an additional source of funding, as implied by the Copenhagen Accord. At this point, the United States is expected to fail to meet its financing commitments for 2020.

GREENHOUSE GAS REGULATION UNDER THE CLEAN AIR ACT

The modern Clean Air Act, passed in 1970, conveys broad authority to EPA to develop regulations to mitigate harm from air pollution. In 2007, the Supreme Court confirmed that this authority applies to the regulation of GHGs.² Subsequently, the agency made a formal, science-based determination that GHGs are dangerous to human health and the environment, which compels the agency to develop regulations to mitigate the harm. Those regulations will take shape in three ways (Figure 1).

Figure 1. Three Pathways to GHG Regulation under the U.S. Clean Air Act



Source: Richardson et al. (2011).

At the time of President Obama’s pledge in Copenhagen in 2009, modeling by the U.S. Energy Information Administration (EIA) forecast emissions in the United States under a business as usual baseline to be 6,689 million tons in 2020 from sources covered by Waxman – Markey.³ The EIA reports emissions in 2005 were 6,741 million tons (EIA 2009a). The target identified in Copenhagen would have reduced emissions by 2020

to 17 percent below 2005 levels, resulting in emissions of 5,595 million tons in 2020. In this section we review actions and trends in place and in progress that have an effect on the expected level of emissions in 2020 with a special focus on changes that were not included in EIA's forecast in 2009.

Mobile Sources

More stringent vehicle fuel economy standards mandated by the Energy Independence and Security Act of 2007 were proposed in 2009 and finalized in May 2010. The standards, which took effect in January 2011, affect cars and trucks beginning with the 2012 model year. The standards impose annual improvements in fuel efficiency of 5 percent per year, raising the fleet average fuel efficiency for light trucks and sport utility vehicles to 30 miles per gallon by 2016, and to 39 miles per gallon for cars, resulting in a combined fleet average of 35.5 miles per gallon. Over the next decade, these standards are expected to roughly offset increases in vehicle miles traveled; over the life of the program, they are expected to reduce GHG emissions from these vehicles by 990 million tons compared to business as usual. Because of these increased fuel economy standards, as well as changing consumer preferences, emissions per driver of newly purchased vehicles fell by 20 percent from October 2007 to July 2012 (Sivak and Schoettle 2012).

Even stricter standards that have since been developed and finalized are expected to require additional fuel efficiency improvements of 40 percent, to be phased in beginning in 2017 and ultimately raising the combined fleet average equivalent to 54.5 miles per gallon by 2025. These standards are expected to reduce GHG emissions by roughly 2 billion tons over the lifetime of 2017-2025 model year vehicles. Complementary regulations addressing medium- and heavy-duty vehicles will take effect in 2014.

Permitting for Stationary Sources

In January 2011, EPA also adopted regulations for preconstruction permitting for major new and modified sources, such as power plants and industrial facilities. Permitting requires site-specific, technology-based review of control technology. Permitting is implemented at the state level, though the technological inquiry is national in scope and subject to EPA oversight. Under current EPA guidelines, this permitting process applies to about 900 construction projects per year at sources that emit large quantities of GHGs.

Performance Standards for Stationary Sources

The third regulatory action still anticipated by EPA will be the implementation of operating performance standards affecting new and, in particular, existing stationary facilities.⁴ The first proposed standards, issued in April 2012 for new fossil-steam power plants, require these plants to achieve a carbon dioxide (CO₂) emissions rate of 1,000 pounds per megawatt-hour; this is based on the performance of a new natural gas combined-cycle plant. A new coal-fired plant would be required to install carbon capture and sequestration (CCS) to achieve this emissions rate. However, the standard includes a provision that allows a coal plant to operate for up to 10 years without CCS if it then installs CCS so that it achieves a 30-year average emissions rate that meets the standard of 1,000 pounds per megawatt-hour. Similar new source performance standards for other source categories – including refineries, pulp and paper, iron and steel, and other emitting sources – are expected to roll out over time.

Once EPA has finalized its standards for new sources in a particular source category, the Clean Air Act requires that the agency begin to develop standards for existing sources in that category. Existing stationary facilities are the source of the largest share of GHG emissions and provide the greatest opportunity for cost-effective reductions in emissions, according to economywide modeling (EIA 2009a). Existing steam boilers at power plants fueled with coal, oil, and natural gas, along with petroleum refineries, account for more than one-third of GHG emissions in the United States. Conceivably, EPA could issue standards that mandate large-scale substitution away from coal to natural gas or nonemitting technologies. However, indications are that EPA will not issue standards that require a major substitution away from coal. Instead, the agency is looking initially at improving the operating efficiency of power plants and refineries while rewarding, but not requiring, the substitution from coal to natural gas.

In its preliminary notice of a proposed rulemaking, the agency indicated that operating efficiency at existing facilities might be improved by 2-5 percent, resulting in a comparable reduction in emissions without changing the electricity output from these facilities (EPA 2008). A 5 percent reduction in emissions from existing coal-fired power plants would amount to over 90 million tons per year, or about 1.4 percent of total U.S. emissions. The agency identified the possibility of

additional emissions reductions of 2-5 percent if coal-fired facilities cofired with biomass. Larger emissions reductions may result if the regulations explicitly enable cofiring with or substitution to natural gas at existing coal-fired facilities as a way to achieve an emissions rate reduction on average.

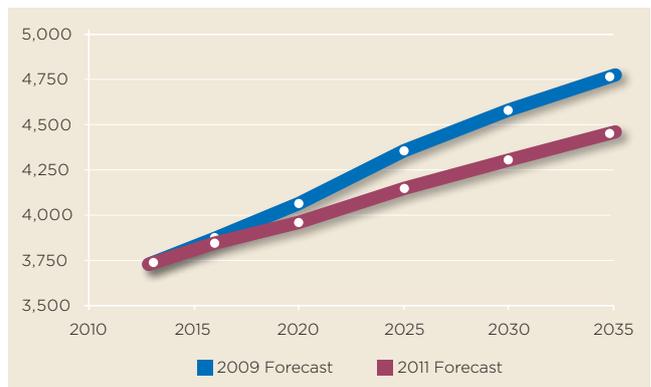
Across all the stationary source categories identified in EPA’s technical documents, emissions total 62 percent of domestic emissions (Burtraw et al. 2011). Existing studies identified by EPA identify opportunities to reduce emissions from these sectors by up to 10 percent, or 6.2 percent of total U.S. emissions. These short-term measures, which include energy and process efficiency improvements, the beneficial use of process gases, and limited material and product changes, have been identified by various authors as “cost-effective,” meaning that they are zero-cost options for a firm after accounting for the cost of energy saved. These calculations apply engineering costs based on case studies, but have been validated in one econometric study of operating efficiency in the electricity sector (Linn et al. 2012).

Perhaps more important than the stringency of the regulations in the long run is how EPA chooses to structure regulations, because this will identify a pathway for ongoing regulatory activity. Figure 1 illustrates that a performance standard approach was chosen over other potential sources of authority under the Act.⁵ The primary responsibility for implementation and enforcement resides with state governments, which will submit plans indicating how they will implement and achieve EPA’s environmental goals. Many authors have encouraged EPA to issue a strong model rule that could be adopted by each state and that would implement a uniform, cost-effective national trading program. However, this raises a dilemma in the potential transfers of wealth across regions. EPA could choose to develop subcategories within a sector based on technology type or region of the country. Departure from a uniform national program would allow emissions rate averaging or trading, for example through regional programs, but the greater the degree of subcategorization, the higher total national costs are likely to be (Burtraw and Woerman 2012). An alternative to a process driven by EPA is one that embraces a variety of approaches proposed by the states, each calibrated to meet or exceed the EPA standard. The structure, timing, and stringency of this regulation are the major sources of uncertainty in U.S. emissions profile.

SECULAR TRENDS IN NATURAL GAS SUPPLY AND ENERGY EFFICIENCY

Over the past three years, expectations about future prices of natural gas and future demand for electricity have evolved substantially, as reflected in adjustments to the energy forecasts produced by EIA in its Annual Energy Outlook (EIA 2009b; EIA 2011). Between 2009 and 2011, forecasts of future natural gas supply expanded multifold, and the expected level of future natural gas prices fell significantly. Coincidentally, forecasts of demand levels and growth are also lower because of the current economic downturn as well as expanded investments in energy efficiency that accumulate over time.

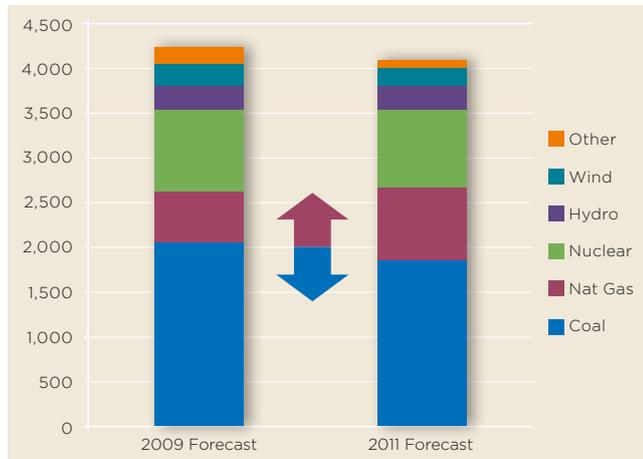
Figure 2. Electricity Consumption (Terawatt-Hours)



Source: Adapted from Burtraw et al. (2012).

To observe how these secular trends affect the electricity sector, we solve Resources for the Future’s Haiku electricity market model two times, once calibrated to EIA’s 2009 forecast and once calibrated to EIA’s 2011 forecast.⁶ The change in electricity demand due to these differing forecasts is illustrated in Figure 2. Reduced demand for electricity leads to a reduction in the amount of electricity generated, yielding CO₂ emissions reductions. The increased supply of natural gas also reduces CO₂ emissions as coal-fired generation is replaced by natural gas generation that is less carbon intensive. The change in generation mix expected in the year 2020 is shown in Figure 3. The combined effect of these secular trends in the electricity sector is expected to reduce CO₂ emissions in 2020 by 240 million tons (Burtraw et al. 2012).

Figure 3. Electricity Generation Mix in 2020 (Terawatt-Hours)



Source: Adapted from Burtraw et al. (2012).

SUBNATIONAL POLICY

Many recent efforts at the state and regional level have sought to reduce emissions of GHGs, either directly, through a cap-and-trade policy, or indirectly, by mandating the increased use of renewables in generating electricity or the displacement of electricity demand with energy efficiency. Significant attention currently is focused on California, which will launch a cap-and-trade program affecting the electricity and industrial sectors in 2013; the program will expand to include the transportation sector, covering 85 percent of GHG emissions in 2015. This program is part of the implementation of California's 2006 law that requires the state to reduce its GHG emissions (including emissions associated with imported electricity) to 1990 levels by 2020. Implementation of the law is expected to yield emissions reductions of 88 million tons per year from business as usual. Regulatory standards and measures are already in place to achieve 78 percent of this emissions target (Burtraw and Szambelan 2012).

Another subnational cap-and-trade program is the Regional Greenhouse Gas Initiative (RGGI), which comprises nine states in the Northeast. RGGI covers emissions from fossil-fueled electric generators and seeks to reduce emissions by 10 percent by 2018 relative to levels observed in 2009, which was the first year of compliance under this program. For several reasons, including secular trends within the electricity sector, the price of RGGI allowances is currently at the program's price floor, resulting in emissions below the level required by the cap. For example, in 2011, emissions

covered by the RGGI program were 44 million tons below the policy's cap. Nonetheless, the price floor in the program auction has returned nearly a billion dollars in revenue that has been directed in large part toward energy efficiency investments in the region (Hibbard et al. 2011).

Policies to reduce GHG emissions have also been enacted at the state level. In 29 states plus the District of Columbia, renewable portfolio standards mandate that a specified percentage of electricity must be generated by renewable sources. In 24 states, fully funded energy efficiency resource standards establish specific, long-term targets for energy savings that must be met through electricity or natural gas energy efficiency programs. Although these policies do not directly reduce GHG emissions, the increased use of renewable generators and the reduction in energy demand decreases the use of carbon-intensive fossil fuels. In most states, the percentage of electricity required to be renewable and the amount of demand displaced by energy efficiency will increase over the next decade, with many policies reaching the maximum stringency around the year 2020.

ADDING UP THE PIECES: PROJECTED U.S. EMISSIONS IN 2020

We have identified three factors that contribute to emissions reductions in the United States. First, under the Clean Air Act, EPA has produced GHG regulations affecting mobile sources and preconstruction permitting. Regulations governing the operation of stationary sources are in development, although at a slow pace. Taken together, these initiatives are expected to achieve emissions reductions of 10.5 percent by 2020 compared to a 2005 baseline. It is uncertain whether these reductions will be fully realized, but the legal and institutional dominoes are in place for this to occur.

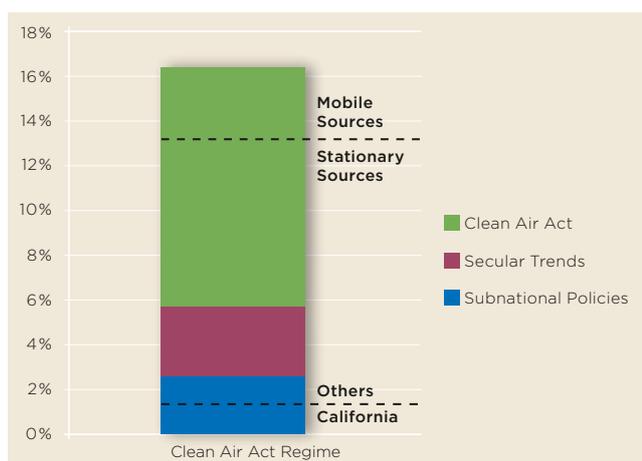
Second, secular trends in the economy, including changing relative fuel prices and the expanded influence of energy efficiency, will lead to additional reductions in the electricity sector that we measure to be 3.3 percent, compared to 2005 levels.

Third, subnational policies are increasingly important. California's goal, embedded in state law; cap and trade in the Northeast (RGGI); and state renewable electricity and energy efficiency programs should contribute additional emissions reductions. These subnational policies alone, without the effects of secular



trends in the electricity sector or any new regulations under the Clean Air Act, put the United States on target to have emissions 2.5 percent below 2005 levels. Total reductions by 2020, accounting for all three factors, are on track to yield emissions reductions of 16.3 percent relative to 2005 levels. The contribution from each of these three factors is displayed in Figure 4.

Figure 4. Components of Emissions Reductions Below 2005 Levels (Percent) under the Clean Air Act Regime



EMISSIONS MAY BE LOWER THAN UNDER CAP AND TRADE

Comprehensive climate legislation proposed in the 111th Congress, known as Waxman – Markey, would have introduced an emissions cap-and-trade system covering

over 84.5 percent of emissions in the U.S. economy. The cap in 2020 was calibrated to be 17 percent below 2005 levels and in alignment with President Obama’s Copenhagen pledge. In fact, the emissions reductions by 2020 were expected by EIA to be substantially greater than that, with the excess accumulating in an emissions bank that would reappear in later years (EIA 2009a). However, the lion’s share of the emissions reductions was expected to occur through offsets; less than half were expected to occur at sources covered by the emissions cap. Further, the legislation would have explicitly or implicitly preempted most of the emissions reductions that are expected to occur under its alternative, the Clean Air Act regime. In Table 1 we report that expected total reductions by 2020 of 16.3 percent relative to 2005 levels within the covered sectors of the U.S. economy will be greater under the Clean Air Act than would have occurred under cap and trade.

EIA’s modeling of Waxman – Markey in 2009 anticipated that the United States would achieve emissions reductions, including offsets, of 33.6 percent by 2020. However, emissions reductions at covered domestic sources were expected to total 10.2 percent. Of the 33.6 percent, 4.7 percentage points were expected to come from domestic offsets, and more than 15 percentage points were expected to come from international offsets – a policy tool unlikely to be available under the Clean Air Act (Richardson 2012). These estimates are presented in the first row under the Cap and Trade Implementation section in Table 1. Further, about 45 percent of these reductions would have contributed to the



emissions bank. If one considers the contribution to the emissions bank ephemeral and likely to appear as actual emissions in a later year, then the permanent emissions reductions from sources regulated under the emissions cap in the U.S. economy would have been 5.6 percent. Counting emissions from domestic offsets, this number would be 8.2 percent.

Some of the factors contributing emissions reductions under the status quo Clean Air Act regime, including changes in the economy since 2009, also would have had an effect under the cap-and-trade program. For example, the change in relative fuel prices – and especially the expanded supply of natural gas – would have occurred with or without cap and trade. However, the emissions reductions that would have been achieved with or without cap and trade are actually quite different because an emissions cap also serves as an emissions floor; that is, it specifies not only the maximum but also the minimum emissions that can occur. Under an emissions cap, because maximum emissions are fixed at the national level, the actions of agents within the economy cannot affect the overall level of emissions. Any effort to reduce emissions by one entity, including state and local governments or private parties, does not affect the overall level of emissions (Shobe and Burtraw 2009; Goulder and Stavins 2011). With an emissions cap, efforts to reduce emissions by one party make possible additional emissions by another party. The emissions floor undermines the contribution of emissions reductions through a number of venues – including aspects of the Clean Air Act or actions by state and local govern-

ments to adopt measures unilaterally that may contribute to local emissions reductions – because leakage of emissions to other jurisdictions would be 100 percent. In effect, a cap-and-trade program at the national level preempts efforts to achieve additional emissions reductions through other means.

Although total emissions may not change under a national cap, agents may undertake actions that shift emissions reductions between different sources under the cap. When additional domestic reductions are achieved within one sector or geographic region, either due to changing trends in the economy or additional policies at the national or subnational level, the marginal cost of reductions decreases. The lower marginal cost leads to a rebound effect with fewer domestic reductions in other sectors or regions and fewer purchases of emissions offsets. For example, a policy that reduces emissions within the electricity sector would yield emissions below what would otherwise be required to attain the cap, which results in a lower allowance price. This reduced allowance price causes emitters in other sectors to increase their emissions and purchase fewer offsets. The net effect is an increase in domestic reductions, but the additional emissions reductions are less than 100 percent of what would have occurred in the absence of the cap.

In the absence of cap and trade, *the first factor* we identified that would yield emissions reductions is the Clean Air Act. The 2007 vehicle standards that took effect in 2011 were included in EIA's baseline projections for Waxman – Markey. However, new standards

proposed in 2011, which take effect in 2017, could very well have been effectively preempted by the passage of Waxman – Markey because the cap would have introduced a price on carbon, resulting in a strong policy argument to let the price substitute for other regulatory efforts. In our central estimate of the cap-and-trade program, we assume that these additional fuel economy standards would not have been finalized, but we do estimate a sensitivity case with the standards in place. Under the Clean Air Act regime, these vehicle standards are projected to achieve additional reductions of approximately 220 million tons in 2020, or 3 percent of benchmark emissions. If they were to occur under the Waxman – Markey cap-and-trade program, however, we estimate that about one-fifth of the emissions reductions would have been partially crowded out by emissions increases elsewhere, resulting in a smaller change in domestic emissions of 175 million tons. Other aspects of EPA's authority to regulate GHGs under the Act, including permitting and performance standards for stationary sources, would have been explicitly preempted.

The second factor yielding emissions reductions under the Clean Air Act regime is secular trends in the economy. Reductions in the electricity sector arising from greater use of natural gas and an expanded role for energy efficiency also would have occurred with Waxman – Markey, but because of the emissions cap, they would not have directly resulted in equivalent emissions reductions. Instead, as described above, some of these reductions would have been crowded out by increased emissions in other sectors of the domestic economy, resulting in approximately four-fifths of the reductions being additional under a national cap.

The third factor yielding emissions reductions in the absence of cap and trade is the subnational effort by state and local governments. Waxman – Markey would not have preempted the ability of California or other states to set their own emissions reduction goals or to pursue related goals, such as renewable energy targets or efficiency standards. These policies might still have emerged even if Waxman – Markey had become law, although arguments to rescind them would have been strong. If they were not rescinded, then under the cap-and-trade system many of these subnational efforts would have become nonbinding, and therefore would have provided no additional emissions reductions. For subnational policies that remained binding, again these emissions reductions would have been partially crowded

out by emissions increases elsewhere, resulting in a smaller change in domestic emissions given the overall national cap.

To estimate that portion of the emissions reductions from the three factors we outline that would have been additional under cap and trade, we solve Resources for the Future's Haiku electricity market model with a reduced-form representation of emissions reduction opportunities for the rest of the U.S. economy, and for the availability of offsets, that is calibrated to EIA's National Energy Modeling System. Haiku includes projections of electricity demand and natural gas prices that correspond to the secular trends discussed above, as well as the subnational policies. These results are reported as the 2012 RFF Forecast under the Cap and Trade Implementation section in Table 1.

We estimate the comprehensive cap-and-trade program proposed for the United States in 2009–2010 would have yielded emissions reductions in the domestic economy of 13.6 percent in 2020, compared to 2005 levels. Total emissions reductions accounting for offsets would total 32.4 percent. This estimate is slightly smaller than that anticipated in the EIA analysis of Waxman – Markey because we use RFF's electricity model and because of other changes in the economy that are accounted for. As with the EIA analysis of Waxman – Markey, a large portion of these reductions would have contributed to the allowance bank and would have reappeared in later years as emissions. Accounting for the ephemeral nature of these reductions, the cap-and-trade program would have achieved domestic emissions reductions of only 7.9 percent in 2020. In contrast, the anticipated emissions reductions under the Clean Air Act regime total 16.3 percent, exceeding those reductions within the United States that would have occurred under cap and trade. Table 1 displays the reductions achieved by these different policies, as well as the portion of reductions achieved by domestic reductions, domestic offsets, international offsets, and non-market offsets.⁷ Below, we examine several sensitivity cases with different assumptions about reductions under a national cap, which are also included in Table 1.

It is especially noteworthy that the comparison ignores the contribution of emissions reductions, both domestically and abroad, through the purchase of offsets. Global emissions may have been lower with the passage of Waxman – Markey, but surprisingly, in the sectors of the domestic economy covered by the emis-

sions cap, they likely would have been more than will occur under the Clean Air Act regime.

Table 1. Emissions Reductions Below 2005 Levels (Percent) in 2020

Scenario	Domestic Reductions	Domestic Offsets	International Offsets	Non-Market Offsets	Total Reductions
<i>Clean Air Act Regime:</i>					
RFF Forecast	16.3	0.0	0.0	0.0	16.3
<i>Cap and Trade Implementation:</i>					
2009 EIA Forecast	10.2	4.7	15.8	3.0	33.6
Adjusted for Banking	5.6	2.6	8.8	3.0	20.0
2012 RFF Forecast (Secular Trends)	13.6	4.2	11.6	3.0	32.4
Adjusted for Banking	7.9	2.4	6.7	3.0	20.0
2012 RFF w/ Fuel Economy Standards	15.9	3.8	10.4	3.0	33.0
Adjusted for Banking	9.0	2.1	5.9	3.0	20.0
2012 RFF w/ Risk Adjusted (10%) Discount Rate	12.3	3.7	7.9	3.0	26.9
Adjusted for Banking	8.7	2.6	5.6	3.0	20.0
2012 RFF w/ Bank Ending in 2035	10.9	3.1	3.0	3.0	20.0
Adjusted for Banking	10.9	3.1	3.0	3.0	20.0

Domestic Offsets

Our central estimate of reductions under Waxman – Markey includes 282 million tons of emissions offsets purchased domestically, or 4.2 percent of 2005 emissions. Although these reductions would not have occurred within the covered sectors of the policy, they would have occurred within the domestic economy. Consequently, one may choose to include these offsets when estimating the amount of emissions reductions that would have been achieved domestically. If we include domestic offsets, we find that Waxman – Markey would have achieved domestic reductions in 2020 of 17.8 percent compared to 2005 levels. Again, these emissions reductions can be adjusted to account for reductions that are banked and will reappear as emissions in a later year. If this is done, we find that Waxman – Markey yields domestic reductions of 10.3 percent, relative to 2005 levels.

It is important to note that the 2005 levels, to which these reductions are compared, count only the emissions from the covered sectors and do not include the sectors in which the offsets would occur. Thus the comparison does not have sectoral equivalence, but that is precisely the intent of offsets, to allow for reductions outside of the covered sectors.

Fuel Economy Standards

In our central estimate of Waxman – Markey, we assume that the fuel economy standards proposed in 2011, and set to take effect in 2017, would not have occurred if Waxman – Markey had been enacted. However, it is possible these increased standards would have been finalized even with the passage of Waxman – Markey. In this case, the standards would provide additional emissions reductions within the transportation sector, although some of these reductions would be crowded out by increased emissions in other sectors and the purchase of fewer emissions offsets. We estimate the inclusion of these fuel economy standards would result in domestic emissions reductions in 2020 of 15.9 percent compared to 2005 levels. If these emissions reductions are adjusted to account for reductions that are banked and will appear in later years, we find domestic reductions in 2020 of 9.0 percent, relative to 2005 levels.

Banking Sensitivities

The Waxman – Markey cap-and-trade program allows for the banking of emissions allowances to be used in later years. However, future session of Congress or regulators could pass additional legislation or rules to weaken or completely abolish the cap-and-trade program, which would have a considerable effect on the value of banked allowances. The evolution of regulations for sulfur dioxide and nitrogen oxides culminating in the proposed Cross State Air Pollution Rule is a precedent for how subsequent regulation can affect the value of banked allowances (Fraas and Richardson 2012). Consequently one would expect firms to anticipate the risk of regulatory change in their banking behavior in future market-based programs.

In our central estimate of Waxman – Markey, we use a discount rate of 7.4 percent to calculate the return on holding allowances; this is the same rate used by EIA in their 2009 analysis of the Waxman – Markey legislation. However, with the risk that banked allowances could become less valuable in the future, investors would likely require a greater annual return in order to hold the allowances (Salant and Henderson 1978). To represent this risk premium, we also modeled Waxman – Markey with a 10 percent risk-adjusted discount rate for allowances, which yields a lower allowance price in the early years of the program and consequently fewer emissions reductions and a smaller purchase of offsets. This 10 percent discount rate results in domestic emis-



sions reductions in 2020 of 12.3 percent compared to 2005 levels. If these reductions are adjusted to account for allowances that are banked in 2020 and will reappear as emissions in later years, we find Waxman – Markey, with a 10 percent discount rate for banking, yields domestic reductions in 2020 of 8.7 percent, relative to 2005 levels.

Another possible result of the risk of banking allowances is that investors may choose to hold allowances for a shorter period of time. In our central estimate of Waxman – Markey we assume banking persists throughout the life of the program until 2050. However, one might expect that investors will hold a smaller portfolio of allowances with a shorter planning horizon in mind due to the risk of future legislation or rules changing their value. We model this outcome using a 15-year planning horizon so that looking forward from 2020 the bank of allowances would be exhausted in 2035. This results in a lower allowance price through 2035 (and a higher price after 2035), which yields fewer emissions reductions and a smaller purchase of offsets in the early years of the program. With this banking outcome, we estimate domestic emissions reductions in 2020 of 10.9 percent compared to 2005 levels. Coincidentally, we find no incremental contribution to the bank occurs in 2020 in this sensitivity case; allowances are banked in earlier years, and these banked allowances are used in later years, but in 2020 the number of allowances allocated equals the number surrendered for compliance with the policy. Thus no adjustment is needed to account for allowances banked in 2020 in this case.

CONCLUSION

In sum, we estimate that the United States is on track to achieve emissions reductions of 16.3 percent by 2020 relative to 2005 levels.

Important uncertainties are associated with the current path of U.S. emissions reduction efforts that would have been lessened with the passage of comprehensive climate legislation. To forecast what will happen next in the United States, one must consider two key touchstones. One is the California program. If the first planned auction happens in November 2012, then the program will almost certainly begin in January 2013, with big implications for the nation. It is likely to face various legal challenges, but for the most part it is expected to survive intact.

Second is the finalization of the new source performance standard for electric steam boilers, which is expected early next year, and EPA's posture in the development of existing source standards. The existing source standards may be more stringent than the technical documents have identified. That is because it is a state-driven process in which states develop implementation plans for EPA's approval. Many states view this as an opportunity to strengthen and broaden the regional trading programs. The uncertainty about the issuance of these standards is a concern, but the legal requirements of the Clean Air Act are clear. A new administration could "slow walk" the regulatory development and delay it for years, but is unlikely to stop it altogether.

Another possibility is the reversal of the Clean Air Act, or at least the removal of authority for enforcing

the GHG rules. This seems far-fetched because it would require an unbalanced legislature and administration. However, a less extreme outcome could be for a new legislature and administration to defund the activities of EPA in developing these rules. This would delay the rules indefinitely.

If the eventualities play out as they currently are aligned, we find that not only is President Obama's pledge in Copenhagen within reach, but emissions reductions within the domestic economy could actually be greater than would have occurred under comprehensive climate policy with cap and trade, as proposed by Waxman – Markey. The reason is that a large portion of the emissions reductions that were expected under cap and trade would have been offsets, whereas many of the factors driving emissions reductions under the current Clean Air Act regime would have been effectively or explicitly preempted under cap and trade.

One might conjecture that advantageous changes in the economy that lead to emissions reductions under the Clean Air Act could have gone the other way, that is, they could have been disadvantageous changes that led to greater use of fossil fuel and greater GHG emissions. The inability of an emissions cap to capture emissions reductions from secular changes has the corollary that it prevents emissions increases resulting from economic growth or the greater use of fossil fuels. However, the course of history is not equally likely in this regard. Throughout developed economies the long-run trend is toward lower emissions intensity of economic activity. Since 1990 the GHG intensity of economic activity in the United States has fallen by 33 percent, along with the intensity of most other forms of pollution, even as overall economic activity and emissions have increased. Harrington et al. (2000) document that ex post assessments of the cost of regulations tend to be less than anticipated, especially for incentive-based policies like cap and trade, often due to mistakes in forecasting the baseline against which necessary emissions reductions would be measured. In other words, an emissions cap set in statute is more likely to end up less stringent than more stringent compared to what was initially anticipated. Incentive-based approaches would have a better environmental performance if they accommodate this fact by including rules to adjust their stringency in response to changing costs (Burtraw et al. 2010). Regulatory approaches do so inherently.

In the short run, to the surprise of many, the United States appears able to meet its mitigation obligations

under the Copenhagen agreement. In contrast, however, the United States seems off-course with respect to meeting its financing obligations under the agreement. Cap and trade provided a vehicle and incentive to direct private capital toward investment in developing countries through the purchase of emissions offsets. It also provided a source of funds for the federal government that could have supported the public fund contribution to the financing obligation. In contrast, under a regulatory approach, these avenues are not available. In particular, international offsets appear to be unavailable as a legal compliance instrument by which to meet GHG reduction standards under the Clean Air Act. The subnational cap-and-trade policies allow for international offsets, but their supply in those programs is limited. Private financing of energy development internationally is already extensive but generally could not be seen as an additional contribution to the outcome of U.S. climate policy. In the absence of cap-and-trade policies in general, and an active offset market in particular, the United States is likely to have difficulty meeting its commitment to finance international investments.

WAY FORWARD

» The U.S. Environmental Protection Agency is expected to finalize its draft new source performance standard for fossil-steam electricity generating units. When that is finalized, it will require the agency to begin to develop its first regulation for greenhouse gases from existing stationary sources.

» The agency also is required to proceed toward development of standards for other sectors. A key issue is how quickly the agency moves to do so.

» The most important subnational policy is California's economy wide cap and trade program beginning in 2013. Meanwhile, the northeast states are currently reviewing their cap and trade program for the electricity sector, with the expectation that it will be tightened.

» Regulatory measures under the Clean Air Act are the default path forward. The issues are how fast measures are developed and the possibility that they are preempted by congressional action. To date, the prospect for congressional action either for or against climate policy seems unlikely.

FOOTNOTES

1. *The president's pledge did not specify whether the reductions would apply to the entire economy or only a set of covered sectors within the economy. We assume that the reductions would apply only to emissions produced by the sectors covered by the Waxman – Markey cap-and-trade bill (H.R. 2454). These covered sectors – including electric generators, fossil-fueled transportation, and industrial sources, as well as other large emitters – composed approximately 84.5 percent of U.S. greenhouse gas emissions in 2005. All references to 2005 emissions levels count only emissions from these covered sectors.*
2. *Massachusetts v. EPA*, 549 U.S. 497 (2007).
3. *All tonnage measures are reported in short tons.*
4. *Standards under §111(b) of the Clean Air Act apply to new sources (these are termed new source*
5. *Richardson et al. (2011) outline the alternatives and the advantages of a performance standard approach. performance standards), and those under §111(d) to existing sources.*
6. *See Paul et al. (2009) for documentation on the Haiku electricity market model.*
7. *The Waxman – Markey proposal included 3 percent of additional reductions that would be achieved by the purchase of international offsets outside of the cap-and-trade system, which we denote as “non-market offsets.”*

REFERENCES

- » Burtraw, Dallas and Matt Woerman, 2012. “*The Consequences of Subcategorization in a GHG Tradable Performance Standard Policy*,” Presentation: Association of Environmental and Resource Economists Annual Conference, Asheville TN (June 4). Manuscript in preparation.
- » Burtraw, Dallas, Karen Palmer, Anthony Paul and Matt Woerman, 2012. “*Secular Trends, Environmental Regulations and Electricity Markets*,” *The Electricity Journal*, 25 (6): 35-47.
- » Burtraw, Dallas and Sarah Jo Szambelan, 2012. *A Primer on the Use of Allowance Value Created under California's CO₂ Cap-and-Trade Program*, Washington: Resources for the Future Discussion Paper 12-23.
- » Burtraw, Dallas, Art Fraas and Nathan Richardson, 2011. “*Greenhouse Gas Regulation under the Clean Air Act: A Guide for Economists*,” *Review of Environmental Economics and Policy*, 5 (2) 293-313.
- » Burtraw, Dallas, Karen Palmer and Danny Kahn, 2010. “*A Symmetric Safety Valve*,” *Energy Policy*, 38(9): 4921-4932.
- » EIA (U.S. Energy Information Administration) 2009a. *Energy Market and Economic Impacts of H.R. 2454*, the American Clean Energy and Security Act of 2009. Washington, DC.
- » ———. 2009b. *Annual Energy Outlook 2009*. Washington DC.
- » ———. 2011. *Annual Energy Outlook 2011*. Washington DC.
- » EPA (U.S. Environmental Protection Agency) 2008. *Technical Support Document - Stationary Source*. Accessed: 9 October 2012 at http://www.eenews.net/public/25/10084/features/documents/2009/03/11/document_gw_05.pdf.
- » Goulder, Lawrence H., and Robert N. Stavins. 2011. *Challenges from State – Federal Interactions in U.S. Climate Change Policy*. *American Economic Review* 101: 253-257.
- » Harrington, Winston, Richard D. Morgenstern and Peter Nelson, 2000. “*On the Accuracy of Regulatory Cost Estimates*,” *Journal of Policy Analysis and Management*, 19(2): 297-322.
- » Hibbard, Paul J., Susan F. Tierney, Andrea M. Okie, and Pavel G. Darling. 2011. *The Economic Impacts of the Regional Greenhouse Gas Initiative on Ten Northeast and Mid-Atlantic States*. Boston, MA: Analysis Group.
- » Linn, Joshua, Dallas Burtraw and Erin Matrangelo, 2012. “*Regulating Greenhouse Gases from Coal Power Plants under the Clean Air Act*,” Washington: Resources for the Future Discussion Paper 11-43.
- » Paul, Anthony, Dallas Burtraw and Karen L. Palmer, 2009. *Haiku Documentation: RFF's Electricity Market Model version 2.0*, RFF Report, (January).
- » Purvis, Nigel, 2012. *Climate of Despair? The Future of U.S. Climate Policy and Global Negotiations*, Washington DC: The German Marshall Fund of the United States, Climate and Energy Paper Series 2012 (March).
- » Richardson, Nathan, 2012. “*Playing Without Aces: Offsets and the Limits of Flexibility under Clean Air Act Climate Policy*,” *Environmental Law* 42(3):735-783.
- » Richardson, Nathan, Dallas Burtraw and Art Fraas, 2011. “*Greenhouse Gas Regulation under the Clean Air Act: Structure, Effects, and Implications of a Knowable Pathway*,” *Environmental Law Reporter* 41:10098-10120.
- » Shobe, William M., and Dallas Burtraw. 2009. *State and Local Climate Policy under a National Emissions Floor*. Discussion paper 09-54. Washington, DC: Resources for the Future.
- » Sivak, M. and Schoettle, B. (2012b). *Average-sales-weighted fuel economy of purchased new vehicles (updated monthly)*. Ann Arbor: The University of Michigan Transportation Research Institute. Available at http://www.umich.edu/~umtriswt/EDI_sales-weighted-mpg.html.

White Paper 1
Gothenburg 2012/10/24

Mistra Indigo
c/o IVL Svenska Miljöinstitutet
Box 53021
400 14 Gothenburg, Sweden
Editor: Maria Kardborn, Communication Manager
www.indigo.ivl.se

Financed by Mistra and FORMAS

Production: Studio81 AB, Vårgårda
Photo: Susanna Blåvarg /Johnér (cover), iStockphoto
Printed by: Prinfo Vårgårda AB, 2012

The *Mistra Indigo* program is aimed at developing tools and instruments that in an internationally coordinated, cost-effective way can support climate efforts from “the bottom up”, i.e. independent of international frameworks. Mistra Indigo is financed by the *Swedish Foundation for Strategic Environmental Research (Mistra)*.

<http://indigo.ivl.se>